This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 03 MANILA 003657

SIPDIS

SENSITIVE

STATE FOR EAP/PMBS, EAP/EP, EB/IFD, EB/TPP/BTA/ANA
STATE PASS USTR FOR BWEISEL AND DKATZ
STATE PASS USAID AND OPIC
TREASURY FOR OASIA FOR AJEWELL
USDOJ FOR MCRAWFORD
USDOC FOR 4430/ITA/MAC/DBISBEE

E.O. 12958: N/A
TAGS: ECON EFIN EINV PGOV RP
SUBJECT: JULY 27-AUGUST 5 UPDATE: PHILIPPINE FINANCIAL
MARKETS HOLDING

REFS: A) Manila 3456, B) Manila 3391, C) Manila 3458,

D) Manila 3593, E) Manila 3421, F) Manila 3061

Sensitive but Unclassified - Not for internet - Protect accordingly.

¶1. (SBU) Summary: President Arroyo and her new economic team went on a media offensive shortly after the President's July 25 State of the Nation Address (SONA) to assure investors, creditors and other Philippine observers that the Administration remains focused on managing the economy and pursuing reforms despite current political challenges (Ref A). While political uncertainties continue as the opposition works to impeach the President (Refs B and C) and new witnesses emerged to discredit her (Ref D), markets continue to hold thus far. The peso closed at 55.91 pesos/$1 on August 5, slightly stronger than on July 26 (Ref E). The stock price index inched upward and foreign investors continued to purchase Philippine stocks. Rates for Treasury bills softened and sovereign spreads for the GRP's medium- to long-term foreign debts continued to hold. However, anxious markets will be looking for signs that President Arroyo remains focused on moving reforms and the economy forward, such as the fate of the amended Expanded Value Added Tax law currently pending with the Supreme Court. End Summary.

-- --
SHARE PRICES INCH UP; FOREIGNERS ARE NET BUYERS
-- --

¶2. (U) The Philippine Stock Price Index (Phisix) rose over the past two weeks since President Arroyo's July 25 State of the Nation Address, buoyed in part by generally positive second-quarter corporate earnings reports. The Phisix broke the 2,000 mark to close the July 26-29 trading week at a six-week high, before profit taking retracted some of the gains. The Phisix closed the August 1-5 trading week at 1,975.60, up 0.8% from July
¶26. As of August 5, the Phisix was up 2.4% from the end of May 2005 (before the audio tapes linking President Arroyo to election fraud surfaced) and up 8.4% from year-end 2004. Net foreign purchases of Philippine stocks, which resumed during the July 18-22 trading week (Ref E), generally continued since the SONA. Net foreign stock purchases totaled 1.9 billion pesos from July 18-August 5, more than offsetting 1.2 billion pesos in net foreign sales during the first half of July.

¶3. (U) GRP officials maintain that political disturbances have thus far not seriously eroded net foreign portfolio investments (which, in addition to stocks, includes investments in securities, money market instruments, and deposits.) June saw net foreign portfolio inflows (estimated at over $300 million) despite the brewing political crisis. The first week of July saw net foreign portfolio withdrawals (about $59 million), followed by net foreign portfolio inflows during the second week of that month. From January 1 to July 15, net foreign portfolio investments were estimated at about $1.9 billion, 12.4 times the level during 2004's comparable period.

T-BILL RATES SOFTEN

¶4. (U) Rates for Treasury bills softened somewhat across all maturities during the GRP's weekly dealers' auction on August 1. The average rate for the 91-day bills dropped by 4.3 basis points to 5.589%, the lowest recorded since mid-October 2003. The average rate for the 181-day bills declined by 0.4 basis points to 7.397%, a four-week low. The average rate for the 364-day bills

dropped by 2 basis points to a three-week low of 8.397%. Although the Government's 6-billion peso offering was more than three times oversubscribed, securities traders commented that hovering political uncertainties prevented bids for the longer-term T-bill maturities from declining more markedly. As of August 1, the average 91-day Treasury bill rate was 33.1 basis points lower than at the end of May 2005 and 220.1 basis points lower than at the end of 2004. The average rate for the 182-day paper was down 43.1 and 148.0 basis points from end-May 2005 and end-December 2004, respectively. As of August 1, the average rate for the 364-day paper had increased by 41.2 basis points from the end of May 2005 but had declined by 148.7 basis points from the end of 2004.

-- -----------
PESO TRADES SIDEWAYS; BSP MAINTAINS NEUTRAL POLICY STANCE
-- -----------

¶5. (U) The local currency, which again weakened to the 56.00 pesos/$1 mark on July 26, traded in the 56.01-56.24/$1 range from July 27 to August 3. Regional currencies reverted to pre-yuan revaluation levels after strengthening briefly. Usually stronger month-end foreign exchange requirements and seasonally strong third-quarter import demand also exerted pressure on the peso. The peso weakened briefly to a four-week intra-day low of 56.24 pesos/$1 on August 1 on new allegations that President Arroyo had personally witnessed payoffs to election officials. The peso strengthened to a 55.86-56.00/$1 trading band on August 4-5 on more modest corporate demand and some weakening of the US$. The peso closed August 5 at 55.91 pesos/$1, up from July 26's closing rate of 56.00 pesos/$1. At August 5's closing level, the Philippine currency was down 2.5% (1.39 pesos) from the end of May 2005 and 0.7% (0.37 pesos) stronger than at the end of 2004.

¶6. (U) The Philippine Monetary Board -- the highest policy making body of the Bangko Sentral ng Pilipinas (BSP, the central bank) -- decided to maintain key policy rates at current levels (i.e., 7% for overnight borrowing and 9.25% for overnight lending) during its rate-setting meeting on July 28. The Monetary Board has raised BSP policy rates only once (by a quarter of a percentage point in April 2005) despite successive increases by the U.S. Federal Reserve Board since mid-2004. Senior Central Bank officials told econoffs that they have not yet seen disturbing shifts from pesos to foreign assets despite narrowing interest rate differentials but they continue to monitor the potentially volatile political situation closely.

SOVEREIGN BOND SPREADS TIGHTEN

¶7. (U) Sovereign bond spreads narrowed between July 25 and August 5 for the Government's medium- and long-term foreign bonds. Spreads for Philippine bonds maturing in 2008, 2010, 2019, and 2025 (the most actively traded in secondary markets) closed at 141, 286, 436, and 480 basis points, respectively, above comparable U.S. Treasuries, tightening from the July 25 closing spreads of 152, 316, 463, and 507 basis points. As of August 4, the respective spreads for the 2008, 2010, 2019, and 2025 bonds were 62, 53, 32, and 24 basis points narrower than at the end of May 2005. Compared with end-December 2004, spreads for these four bond maturities had tightened by 138, 114, 71, and 40 basis points, respectively.

Comment

¶8. (SBU) Immediate economic prospects remain stable. For now, businessmen and investors appear to be willing to give President Arroyo and her economic team the benefit of the doubt that reforms will continue. However, with more surprises likely on the political front as the political controversies drag in the weeks and months ahead, the business and investor communities will be increasingly anxious for concrete signs that President Arroyo and her Cabinet have not lost their focus on reforms and on the economy. Many continue to cite the fate of the amended Expanded Value Added Tax (EVAT) law as the major litmus test of whether the GRP will be able to continue painful but necessary economic reforms. The Supreme Court, which issued a Temporary Restraining Order (TRO) on the implementation of the amended EVAT law on July 1 (Ref F), is expected to issue a decision before the end of August. Several senior GRP officials told econoffs they are confident that the Supreme Court will rule in the Government's favor and allow the EVAT law to go through, but private sector observers are less optimistic.